

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Assembly Revenue and Taxation Committee Analyst: Rachel Coco Bill Number: AB 1767
Related Bills: See Legislative History Telephone: 845-4328 Introduced Date: March 17, 2005
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Liquidation Of Securities/Reimbursement Due To Erroneous Actions/FTB Provide Taxpayer Address Information To DOJ For Locating Unregistered Sex Offenders

SUMMARY

This bill would:

1. require financial institutions, upon request, to liquidate a taxpayer's securities to satisfy the taxpayer's tax liability,
2. provide an exception to the underpayment of estimated tax penalty due to an erroneous action by the Franchise Tax Board (FTB),
3. incorporate into the Revenue and Taxation Code (R&TC) a provision of the Penal Code that provides an exception to FTB's general disclosure law, and
4. allow reimbursement to persons for external charges and fees caused by an erroneous action by FTB.

Each provision of this bill is discussed separately.

PURPOSE OF THE BILL

According to the author's office, the purpose of this FTB sponsored bill is to allow for the effective collection of tax debts and to prevent taxpayer's from being unfairly penalized for FTB errors.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative January 1, 2006, with the exception of the disclosure provision that has a specified operative date for requests made on or after January 1, 2005.

POSITION

Support.

On December 1, 2004, the Franchise Tax Board voted 2-0, with the representative from the Department of Finance abstaining, to sponsor the provisions of this bill.

Board Position:

<u> X </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Gerald H. Goldberg

4/21/05

SUMMARY OF ECONOMIC IMPACT

Estimated Revenue Impact of AB 1767 Years Beginning On or After January 1, 2006 (In Millions)			
	2005/2006	2006/2007	2007/2008
Liquidation Of Securities	+\$3.6	+\$1.0	+\$1.0
Underpayment Of Estimated Tax Penalty Relief For Erroneous Actions By FTB	None	None	None
Disclosure Exception	None	None	None
Reimbursement Of Third-Party Fees Due To Erroneous Action By FTB	Insignificant loss*	Insignificant loss*	Insignificant loss*
Total	+\$3.6	+\$1.0	+\$1.0

*Insignificant equals a loss of less than \$150,000

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

The revenue discussions are included, below, with each provision.

1. LIQUIDATION OF SECURITIES

ANALYSIS

FEDERAL/STATE LAW

Generally, federal law allows the IRS to seize any real or personal property of a delinquent taxpayer, whether the taxpayer or an agent holds the property. The IRS may sell the property and apply the proceeds to the unpaid taxes. There are exemptions to seizure for certain kinds of income and property, such as unemployment benefits, clothes, and tools. For non-cash assets such as uncertificated¹ securities, the IRS issues a levy to a taxpayer's financial institution and the institution liquidates the asset and forwards the proceeds to the IRS.

Current state tax law authorizes FTB to issue levies called orders to withhold (OTWs) to various financial institutions, including brokerage firms, that have in their possession or control personal property or other things of value that belong to a debtor. A financial institution is required to transmit an amount not to exceed the amount specified in the levy to FTB not less than 10 business days after receiving the OTW.

If the assets consist of non-cash items, such as certificated stock or securities held in a brokerage account, the financial institution freezes enough securities to cover the OTW. Since FTB lacks the authority to require the financial institution to liquidate the security to satisfy an OTW, FTB has these types of assets liquidated through a warrant seizure and auction process.

¹ Uncertificated securities are holdings where no paper record is readily accessible, such as mutual funds.

Current state law provides that uncertificated securities may only be reached by legal process on the issuer of the security at the issuer's executive office. Such information is often unavailable to FTB or if information shows that the issuer's executive office is outside California, FTB would be unable to issue a warrant for seizure and sale. As a result, FTB generally does not pursue the seizure and sale of uncertificated securities.

Current state law requires a financial institution, person, or securities intermediary to liquidate the financial assets, including securities, of an individual obligor who owes child support when a local child support agency or FTB issues a levy for child support obligations.

THIS PROVISION

This provision would require financial institutions or those that maintain, administer, or manage an asset to fulfill the terms of an OTW by liquidating a taxpayer's non-cash assets within 30 days of receiving an OTW from FTB. The provision would require the proceeds from the liquidation, minus any reasonable commissions or fees, to be submitted to FTB within five days of the liquidation.

This provision provides that if the value of the assets to be liquidated exceeds the tax liability, the taxpayer may choose which assets are to be sold to satisfy the liability. If the taxpayer does not provide instructions for liquidation, assets will be liquidated beginning with the assets purchased most recently.

The provision provides that a financial asset would include a security, uncertificated security, certificated security, security entitlement, or a securities account, as defined within the Commercial Code.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

AB 1752 (Assembly Budget Committee, Stats. 2003, Ch. 225), requires a financial institution, person, or securities intermediary to liquidate the financial assets, including securities, of an individual obligor who owes child support when a local child support agency or FTB issues a levy for child support obligations.

OTHER STATES' INFORMATION

The states surveyed include *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

In speaking with representatives from each states' Department of Revenue (DOR),

- *Illinois* believes they may already have the legal authority to require liquidation by brokerage firms. However, they have yet to test the process and are currently creating a plan to do so.
- Similar to California, *Michigan* administratively seizes the asset and converts it into cash. However, an auction is not required.
- In the states of *Massachusetts*, *Minnesota*, and *New York*, the financial institution liquidates non-cash assets and forwards the proceeds to the DOR, similar to the process that this provision would require.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Collections Discussion

Currently, FTB collects approximately \$3 million annually from the liquidation of securities from over 400 accounts. The total annual cost to the department for liquidating these securities is approximately \$350,000, as a result of the costs involved to seize the securities and hold an auction to liquidate them. Typically, the average cost per taxpayer account to conduct an auction is \$785. These costs reduce the proceeds that FTB receives from security liquidations. This provision would eliminate those costs, thereby increasing collections from liquidations by \$350,000 annually. In addition, over 550 accounts annually are released because it is not cost effective to liquidate those securities. Liquidation of those securities under this provision would increase collection revenue by over \$650,000 annually (550 accounts x \$1,200 average account balance).

Currently there is \$600,000 in mutual fund accounts that cannot be liquidated under present law and \$500,000 in stocks that are uncertificated. This provision would make those securities collectable for a total of \$1.1 million.

In addition, since the current liquidation process takes from 12 to 18 months to complete, there would be an acceleration of six months of collection revenue or \$1.5 million in the first year.

In total there would be an increase in collection of \$3.6 million in the first year (\$350,000 in reduced costs + \$650,000 in collections from smaller accounts + \$1.1 million collection of mutual fund liquidations+ \$1.5 million in acceleration) and \$1 million annually thereafter (\$350,000 in reduced costs + \$650,000 in collections from smaller accounts).

2. UNDERPAYMENT OF ESTIMATED TAX PENALTY RELIEF FOR ERRONEOUS ACTIONS TAKEN BY FTB

ANALYSIS

FEDERAL/STATE LAW

Under current state and federal laws, taxpayers generally are subject to a penalty for any underpayment of estimated tax. The penalty is an amount equal to the underpayment rate² multiplied by the amount of the underpayment.

State and federal laws have expressly allowed exceptions to the estimated tax underpayment penalty when the underpayment resulted from a specified legislative change.

THIS PROVISION

This provision would provide an exception to the estimated tax underpayment penalty that results from an erroneous levy, erroneous processing action, or erroneous collection action taken by FTB.

² The underpayment rate is the sum of the Federal short-term rate, as determined by the Secretary, and three percentage points.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not impact the department's programs or operations.

LEGISLATIVE HISTORY

SB 14 (Campbell/Runner, 2005/2006) would provide a general exception to the underpayment of estimated tax penalty for all future tax law changes. SB 14 also would provide a specific exception to underpayment penalty for individuals who underpaid their estimated taxes during the 2004 taxable year due to the suspension of the Teacher Retention Credit. SB 14 is currently in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Research showed that these states have similar provisions to California's existing underpayment of estimated tax penalty provisions and allow exceptions to the penalty in specified instances. However, it was unclear whether underpayments made due to erroneous actions taken by the state revenue departments were excluded from the penalty.

FISCAL IMPACT

This provision would not impact the department's costs.

ECONOMIC IMPACT

This provision would not impact state income tax revenue.

3. DISCLOSURE EXCEPTION

ANALYSIS

FEDERAL/STATE LAW

Generally, FTB is prohibited under federal law and an interagency agreement with the IRS from disclosing taxpayer information that FTB receives from the IRS, which may include a taxpayer's address.

Under current state tax law, FTB is prohibited from disclosing any confidential taxpayer information unless an exception to the general disclosure law specifically authorizes the disclosure.

Recently enacted legislation (AB 1937, Stats. 2004, Ch. 127) added a provision to the Penal Code that requires state agencies, including FTB, to disclose address information to the Department of Justice (DOJ) for purposes of locating unregistered sex offenders. This requirement is without regard to any other provision of state law, including the taxpayer information disclosure law discussed above.

In addition, other recently enacted legislation (AB 488, Stats. 2004, Ch. 745) requires DOJ to make specified information, including home addresses, about certain sex offenders available to the public via the Internet.

THIS PROVISION

This provision would incorporate a recently enacted provision of the Penal Code into the R&TC as a matter of code maintenance. The provision operates as an exception to the general disclosure law that taxpayer information is confidential.

IMPLEMENTATION CONSIDERATIONS

Implementing this proposal would not impact the department's programs or operations and would help ensure that confidential taxpayer information is handled as required by law.

LEGISLATIVE HISTORY

AB 1937 (Corbett, Stats. 2004, Ch. 127) added a provision to the Penal Code to require state agencies to disclose address information to DOJ for purposes of locating unregistered sex offenders.

SB 1310 (Vasconcellos, Stats. 2000, Ch. 940) added a provision to the R&TC to require FTB to provide address information to DOJ for purposes of locating individuals with outstanding arrest warrants.

OTHER STATES' INFORMATION

This provision is essentially a matter of code maintenance; therefore, a comparison of other states would not be relevant.

FISCAL IMPACT

This provision would not impact the department's costs.

ECONOMIC IMPACT

This provision would not impact state income tax revenue.

4. REIMBURSEMENT OF THIRD-PARTY FEES DUE TO ERRONEOUS ACTION BY FTB

ANALYSIS

FEDERAL/STATE LAW

The IRS is authorized to abate the unpaid portion of the assessment of any tax or any liability that is erroneously or illegally assessed. In addition, the IRS has discretion to abate any interest assessed due to a deficiency or payment attributable to any unreasonable error or delay by an IRS officer or employee acting in his or her official capacity. Further, the IRS is required to abate any portion of any penalty or addition to tax attributable to erroneous written advice given by an IRS officer or employee acting in his or her official capacity in response to a specific written request.

Current state law provides statutory authority for FTB to reimburse a person for imposition of bank charges incurred by the taxpayer as the direct result of an erroneous levy by FTB. Bank charges include a financial institution's customary charge for complying with the levy and reasonable charges for overdrafts that are a direct consequence of the levy. The charges must have been paid by the person and not waived or reimbursed by the financial institution. A person has 90 days from the date of the erroneous action to file a claim with FTB. FTB is required to respond to the claim within 30 days.

Under current state law, a taxpayer may file a claim with the Victims Compensation and Government Claims Board (VCGCB) for other monetary losses believed to have been caused by the action or inaction of any state agency. Claims may include, but not be limited to, a refund of a tax, fees, or penalties.

Effective August 2004, a taxpayer must pay a fee of \$25 with a claim that is filed for money or damages against the state. In addition, there is a surcharge of 15% on any claim that is granted by VCGCB. This surcharge, along with the claimant's filing fee, is to be paid by the governmental agency against which the claim was made.

Summary of Suggested Amendments

Amendment 1 is provided to address the department's technical concern discussed below.

THIS PROVISION

This provision would allow persons to file a claim with FTB for reimbursement of charges imposed by third-party businesses as a result of an erroneous levy, processing action, or collection action by FTB.

This provision would provide that reimbursement of charges or fees would occur only if FTB determines that the following conditions have been satisfied:

- the erroneous action was caused by an error made by the department,
- prior to the erroneous action, the person responded to all contacts and requests by the department, and
- the charge or fee has not been waived or otherwise reimbursed by the third-party.

This provision also would allow FTB the discretion to extend the 90-day period for filing a claim.

This provision specifies that charges and fees that would be reimbursed would be limited to the usual and customary charges and fees imposed by a third-party in the ordinary course of business.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

TECHNICAL CONCERNS

This provision provides three conditions that must be met in order for FTB to reimburse third-party charges or fees. However, the language of the bill states that "both" conditions must be met. Amendment 1 is included to correct the language to remove the term "both."

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Of the states surveyed it appears only *Michigan* and *New York* have statutory authority to reimburse persons for fees incurred as a result of an erroneous action taken by the states' Department of Revenue.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Discussion

Based on departmental information over a five-year period, it is estimated that 5,000 persons or taxpayers would have been eligible for relief of charges, fees, and penalties under this proposal. The total amount of relief over the five-year period is estimated to be approximately \$500,000. Therefore, the average loss is projected to be \$100,000 (\$0.5 million/5) per year. A greater revenue loss could result in any year due to an isolated incident, for example, a large computer malfunction affecting multiple taxpayers. Based on discussion with departmental staff, this situation could possibly occur, yet, historically is classified as the exception.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1767
As Introduced March 17, 2005

AMENDMENT 1

On page 6, line 1, strikeout "both of" and insert:

all of